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SPECIAL REPORT

The Consequences of Population Aging on Private Pension, Fixed Saving, and Asset Markets*

As part of its continuing focus on public policies to increase U.S. saving and investment, the ACCF Center for Policy Research presents a summary of a new study of the long-term implications of tax policy on pension funding by John Shoven, dean of the College of Arts and Sciences at Stanford University and ACCF Center for Policy Research board member, and Sylvester J. Schieber, vice-president of the Wyatt Company.

Background

In the United States the group of people born from 1946 through 1964 have come to be known as the baby boom generation. After the end of World War II, birth rates in the United States jumped to a level significantly above long-term trends and stayed above generally expected levels until the mid-1960s. Because of the high birth rates over this period, the number of people born from 1946 to 1964 comprise an unusually large segment of the total U.S. population. Because of its size, the baby boom generation has had a more significant effect on various facets of the social structure during its lifetime than other comparably aged segments of the population, according to the study by John Shoven, dean of the College of Arts and Sciences at Stanford University, and Sylvester J. Schieber, vice-president of the Wyatt Company.

Given the predictability of the aging process and the evolving patterns of retirement behavior among workers, it is important to consider as far in advance as possible the implications of their retirements on existing social and economic institutions. The two largest sources of cash income for retirees today are Social Security and employer-sponsored tax-qualified retirement plans. Shoven and Schieber observe that policymakers have focused much more on the long-term status of the Social Security system than on the employer-sponsored pension system. As a prelude to their study of private pension fund saving, Shoven and Schieber briefly describe the outlook for the Social Security program.

Social Security Funding and the Baby Boom Generation

For some time, policymakers have been aware that the baby boom generation will pose a particular set of challenges for the Social Security program. Traditionally, the Social Security program in the United States had been run largely on a pay-as-you-go basis. The 1983 Social Security Amendments, anticipating the special burden that baby boomers' retirements would place on workers in the future, included provisions for accumulating a substantial trust fund to prefund some of the benefits promised to the boomers. In other words, the baby boom generation was expected to prefund a larger share of its own benefits than prior generations had prefunded to their own Social Security retirement income. The 1983 amendments also reduced the benefits promised to the baby boom generation by gradually raising the age at which full benefits would be paid to age 67 after the turn of the century.

In the first projections after the passage of the 1983 Amendments, Old Age, Survivors, and Disability Insurance (OASDI) trust funds were projected to be solvent until at least 2063. Actuaries estimated that the trust fund would grow from around $27.5 billion in 1983 to about $20.7 trillion in 2045. However, in almost every year since 1983, the estimates of the accumulations in the OASDI trust funds have been revised downward. The most recent projection, published in April 1993, suggests that the trust funds will accumulate to only about $5 trillion by 2025, and then decline to a zero balance sometime during 2036. At that time the baby boomers will range in age from seventy-two to ninety. Although their numbers will be

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declining there will still be significant numbers of them depending on their retirement benefits to meet their ongoing needs.

But as the baby boom generation moves fully into retirement, the projected financing situation for Social Security turns decidedly negative. During the second twenty-five year period reflected in Table 1, when the majority of the baby boomers expect to get the bulk of their lifetime benefits, the projected OASDI outlays exceed revenues by 20 percent. In other words, every bit of evidence available to national policymakers today indicates that Social Security will not be able to provide the benefits currently being promised to the baby boom generation on the basis of inherent benefits promises now being held out to them and existing funding legislation.

Employer-sponsored Retirement Plan Funding and the Baby Boom Generation

Employer-sponsored retirement programs typically operate in a significantly different environment than the federal Social Security program. While the federal government operates its own employer-sponsored retirement programs largely on a pay-as-you-go basis, most state and local governments prefund retirement obligations on some basis, and private employers are required to fund their retirement obligations on the basis of rules laid out in the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC).

ERISA became law in 1974. Its purpose was to provide more secure retirement benefits for all the participants in tax-qualified plans. Among other things, ERISA established rules for including workers in plans, rules for vesting or guaranteeing benefits, and requirements that benefits be funded on a scheduled basis.

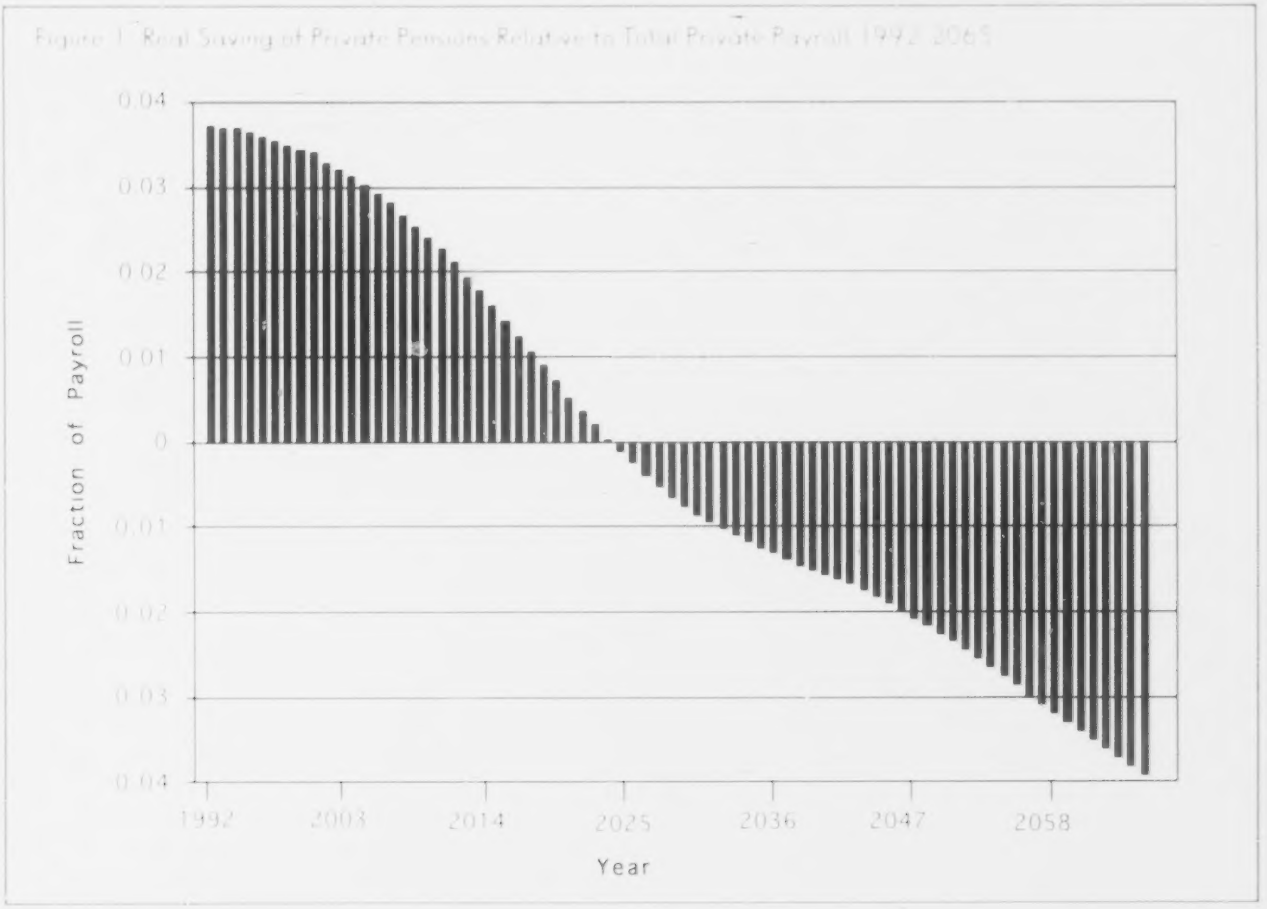
For defined contribution plans, the funding requirements are straightforward. On the date that a contribution to the plan is required by, the plan rules the employer makes a contribution to the plan equal to the obligation. In this case, the employer is not obligated to make any additional contributions for prior periods. The ability of the plan to provide an adequate retirement benefit will depend heavily on the size of the periodic contributions and the investment returns to the assets in the plan.

For defined benefit plans, the funding requirements are somewhat more complicated because defined benefit plans promise future benefits. If a worker enters a firm at age twenty-five and works until age sixty-five and he is retired under the plan for twenty years before dying, his span of life under the plan is sixty years. The essence of ERISA funding requirements for defined benefits plans is that the employer gradually contributes enough to the plan so the promised benefits will be fully funded at the point a worker retires. The annual contribution to the plan is determined on the basis of an actuarial valuation of the plan's obligations and assets, and specific funding minimums and maximums specified in the law. The funding minimums in the law are to assure that employers are laying aside money to pay promised benefits. The funding maximums are in the law to assure that extraordinary contributions are not made to the plan simply to avoid paying federal taxes.

Table 1: Social Security Income and Cost Rates as Projected Under Current Law

Period	Income Rate	Cost Rate	Over or Under (-) Funding as % of Income Rate
1993 - 2017	12.72	11.87	-6.76
2018 - 2042	13.10	15.73	-20.08
2043 - 2067	13.18	17.28	-31.11

Source: 1993 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (April 1993) p. 26.



Recent Tax Code Revisions Affecting Private Pensions

From the passage of ERISA in 1974 until the early 1980s concerns about benefit security held the upper hand in driving federal policy towards pensions, observe Shoven and Schieber. Since 1982, however, policies aimed at limiting tax leakages related to employer-sponsored retirement plans have played the dominant role. While a number of tax law changes have had an effect on defined contribution plans since 1982, the effects on defined benefit plans have been considerably more profound.

In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) reduced and froze for a period of time the dollar funding and contribution limits for both defined benefit and defined contribution plans. TEFRA also established new discrimination tests that had the practical effect of lowering contributions for many plans. The next year the Deficit Reduction Act extended the freeze in the funding and contribution limits established by TEFRA. The Tax Reform Act of 1986 again reduced and froze funding and contribution limits for tax qualified plans. The Omnibus Budget and Reconciliation Act of 1987 (OBRA 87) also significantly limited the funding of defined benefit plans. Finally, the Omnibus Budget Reconciliation Act of 1993 (OBRA 93) included provisions that reduce the level of individual employee's compensation that can be considered in funding and contributing to tax qualified plans. The practical effects of the OBRA 93 provisions will be to further limit the funding of employer-sponsored retirement programs.

Outlook for Pension Funding and Net Saving

According to Shoven and Schieber's analysis, the assets of the total private pension system will continue to grow in nominal terms for the next sixty years. However, this growth is almost continuously slowing. For instance, in 1993 the benefits (payouts) of the defined benefit and defined contribution private plans combined are 82.3

percent of total contributions. This means, of course, that there is a net inflow of funds into the total system, even without taking into account the investment return on the $3 trillion asset pool. However, by the year 2006 benefits are projected to be 102.4 percent of contributions and aggregate benefits are expected to continue to outstrip contributions for the entire remaining period through 2065. By 2025 benefits are projected to be 163 percent of contributions.

The importance of this analysis, observe Shoven and Schieber, is that pensions will gradually cease being the major engine of aggregate saving that they have been for the past twenty years or more. The total real saving of the private pension system (projected contributions less benefits plus real inflation-adjusted asset returns) relative to the projected total private payroll in the economy for 1992 to 2065 are shown in Figure 1. Total private payroll is used as the scaling factor simply because it is a readily available by-product of the Social Security forecasting operation. Figure 1 shows that under the authors' assumptions the pension system continues to generate significant investable funds for the American economy for the next twenty years or so. In fact, the decline is very minor for about the next ten years and then it steepens considerably. But by 2024, the pension system is projected to cease being a net source of saving for the economy. In fact, the pension system will then become increasingly a net dissaver. By 2040, the net real dissaving is more than 1.5 percent of payroll and by 2065 the negative saving is projected to reach almost 4.0 percent of payroll. This change of the pension system from a large net producer of saving to a large absorber of saving or loanable funds will likely have profound implications for interest rates, asset prices, and the growth rate of the economy. By the third decade of the twenty-first century, the real assets of the private pension system will shrink and the system will at least temporarily cease being a source of new investment funds for the economy.

Impact of Pension Asset Prices

Another concern raised by Shoven and Schieber is that as pension funds become net sellers, pension assets may fall in price. Under Shoven and Schieber's conservative assumptions, the early part of the third decade of the next century is likely to be the period of time when the pension system begins to be a net seller . This could depress asset prices, particularly because the demographic structure of the United States does not differ that greatly from Japan and Europe, which also will have largely elderly populations at that time. If the asset price effect occurs, it would likely affect all long -term assets. High real interest rates could depress the prices of stocks, bonds, land, and real estate.

Conclusions

The authors stress that public policymakers have completely ignored the long-term implications of tax policy on pension funding in an attempt to minimize the short-term structural imbalances underlying federal fiscal policy.

In addition, the national saving generated by the private pension system can be expected to decline from current levels, gradually for about a decade and then far more steeply. With the conservative assumptions about the rate of return earned by pension assets employed in the study, the pension system would cease to be a source of saving around 2024. ■

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